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DIRECTORATE OF INTELLIGENCE

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China: Potential for Political Crisis (C NF)

Summary

Although Party General Secretary Zhao Ziyang remains powerful, his standing has slipped as a result of the reversal of his economic policies at the party's plenum last September. This memorandum speculates on the circumstances that could lead to his removal, his possible successors, and the broader implications of a change in leadership. It is admittedly a worst case scenario, but if Zhao is unable to forge a consensus to deal with current economic problems, and they persist or worsen, we believe Zhao's critics could make him the scapegoat for the reform program's many shortcomings. [redacted]

If Zhao fell, Deng and other party elders probably would turn either to a member of their own generation to restore discipline within the party and Chinese society at large, or more likely in our view, a younger party leader not tainted by corruption and the ills of the floundering reform

[redacted]

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program to take over as general secretary. Having no one of Zhao's stature and reformist credentials to turn to, we speculate that Deng and other reformers would, with misgivings, accept Politburo Standing Committee member Qiao Shi as a compromise choice. Other younger leaders, such as Premier Li Peng, lack the institutional base or managerial ability to win broad party support. No matter who succeeded Zhao, however, we believe a successor would find himself hamstrung by conflicting views within the leadership, the party's declining prestige, and the general weakening of the central government; he would thus be unable to pursue anything but the most cautious course on reform

Zhao: Down But Not Out

By all accounts, Zhao's economic policies took a beating at last fall's leadership meetings. conservative reformers--especially Premier Li Peng and Vice Premier in charge of economic affairs Yao Yilin--sharply criticized Zhao's inflation-generating, high-growth policies and won endorsement for a period of "readjustment" to cool China's overheated economy.

At a minimum, we believe that Zhao has had to acquiesce to the adoption of outmoded administrative controls while trying to protect and promote market-oriented reforms.

he continues--with Deng's support--to have a key say in both domestic and foreign policy. Deng, in fact, publicly reiterated on 7 November to Uruguayan President Sanguinetti that Zhao and Li Peng are responsible for China's affairs. Even if Deng has lost some confidence in Zhao, we believe he would be reluctant to dump his designated successor for fear of weakening his own authority and shaking foreign confidence in China's stability and reform program. Moreover, in our judgment, there is no one else that Deng could turn to who both shares his reformist vision and possesses the prestige necessary to bolster domestic and foreign confidence in the leadership the way Zhao was able to do when Hu Yaobang fell.

Nevertheless, we suspect that Zhao could become increasingly vulnerable and even fall within the next 12 to 18 months if China's economic and social problems persist or worsen. Although Zhao is reputed to have a strong base in the provinces, because of his support for the decentralization of authority and promotion of a high-growth, loose-credit policy, his support within the Politburo and other central party organs still appears to be fairly weak. As best we can judge, Zhao remains heavily dependent on the backing of Deng and the acquiescense of other party elders

Were some of Zhao's more powerful critics among party elders such as Bo Yibo to join forces with senior military and security officials against Zhao in a crisis, as they did against Hu Yaobang, we doubt that Deng would be able or even willing to save him.

China's Overheated Economy Not Slowing

China's leaders are searching for ways to dampen inflation and slow excessively rapid industrial growth that is intensifying shortages of raw materials and energy. Retrenchment policies adopted over the past five months have been largely ineffective, and industrial production, which was up 17 percent in 1988, grew at a faster rate in December than in November. Beijing recently has imposed new taxes, spending controls, interest rate hikes, and restrictions on exports of scarce goods. [redacted]

We believe these policies are not likely to cut urban inflation in 1989 from much below its current level of more than 30 percent, the highest in nearly 40 years:

- Beijing has avoided addressing some of the most serious causes of inflation. Concerns about worker unrest in urban areas have led Chinese leaders to boost government subsidies for food and rent. Beijing also continues to make low-interest loans available to state factories and refuses to close enterprises that use raw materials wastefully.

- Beijing has had only partial success controlling the money supply; interest rates have been raised twice in the last five months but remain less than half the inflation rate. In addition, powerful provincial and municipal leaders often override Beijing's orders to restrict loans and approve their pet construction projects. [redacted]

Moreover, pressures will build this spring to reverse at least some of the austerity measures. [redacted] Beijing also is concerned with the intense criticism peasants leveled last fall, when credit shortages in the countryside forced the government to purchase the fall harvest with IOUs instead of cash. [redacted] The anticipated rollback of credit restrictions would funnel even more money into the economy and accelerate inflation. Even if controls remain in place and growth in the money supply slows in the second and third quarter, however, the infusion of funds in the first three quarters of 1988 will keep inflation at about its current level for at least the next year. [redacted]

[redacted]

Glimpses of a Crisis

We speculate that any one of several scenarios could trigger such a crisis. Zhao could become a scapegoat if:

- The economy deteriorates sharply, with soaring inflation--already at its highest rate in nearly 40 years--eroding public confidence in the party.
- Popular discontent, already high because of inflation and growing official corruption, sparks widespread student and/or worker unrest that party elders perceive as a challenge to the party's authority.
- Party elders, including Deng, perceive the reform program to be adrift and slipping into the trap of stagflation that has crippled reform in Hungary and Yugoslavia [redacted]

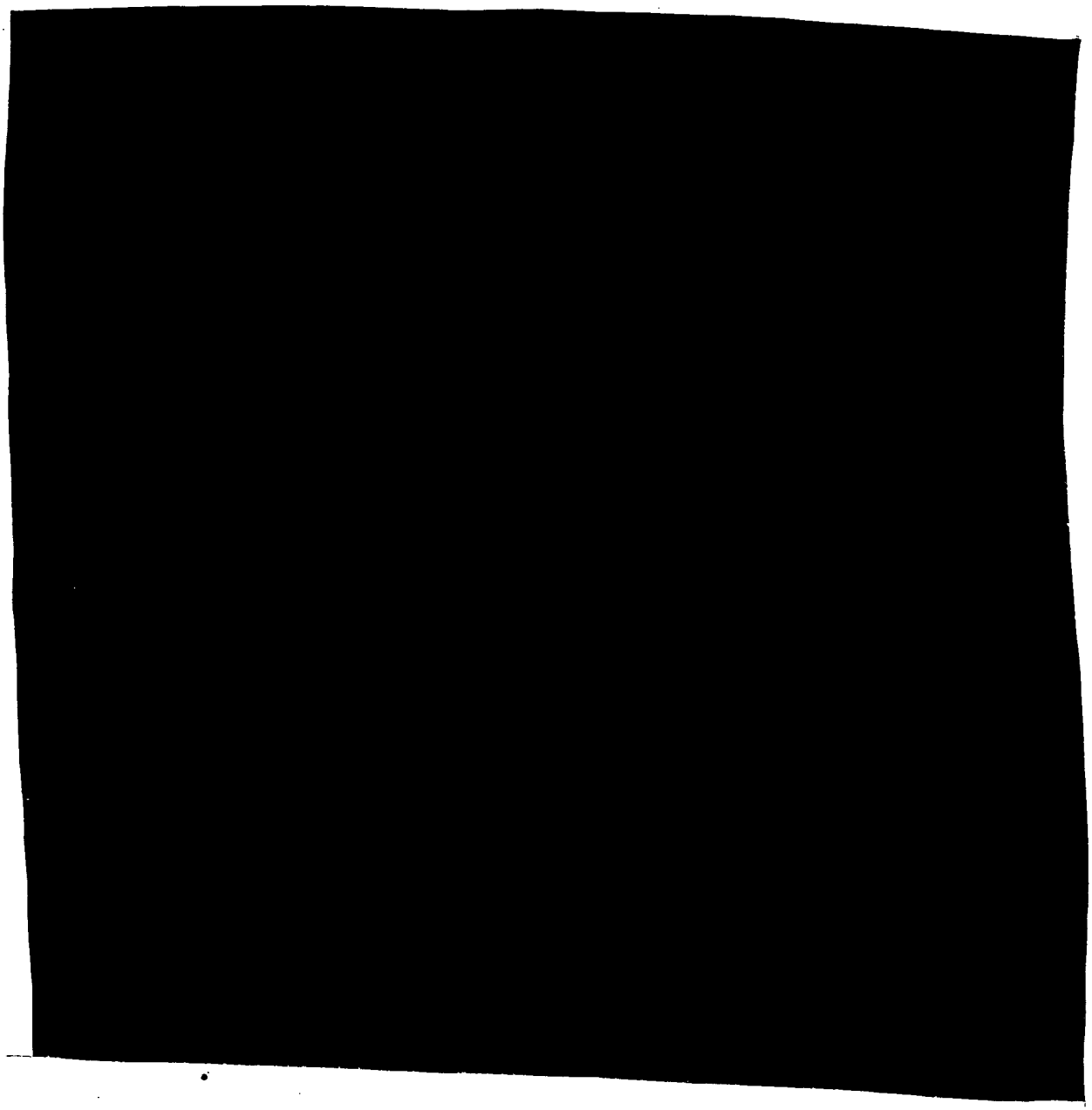
Even though all of China's leaders share responsibility, Zhao remains most closely identified with market-oriented and political reforms that lie at the root of today's problems. His critics have long had reservations about Zhao's efforts to liberalize the economy and open the political system, fearing that these steps could undermine the party's authority and by extension threaten their own power and privileges. They would have little difficulty constructing a list of charges to justify his ouster. [redacted]

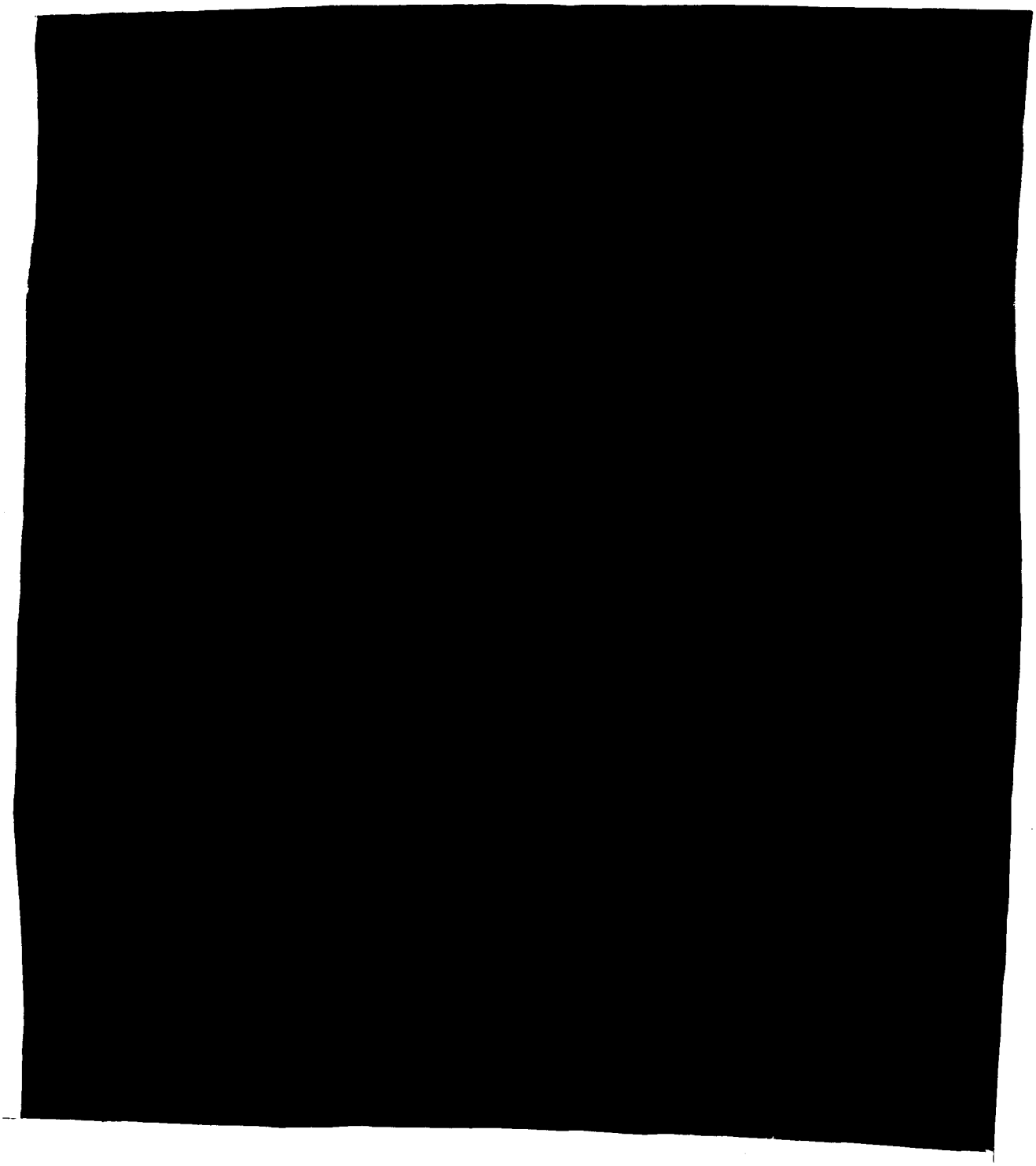
Should there be widespread unrest, Zhao would be especially vulnerable to the charge that under his direction, the party has lost its ability to maintain social order. Conservative party leaders, who place a high value on social discipline, are already disturbed by rising crime rates and the breakdown of conventional mores. Corruption has grown rapidly under Zhao's market-oriented reforms, reaching the point where little business can be transacted without resort to bribery, badly tarnishing the party's image. Zhao's ability to combat corruption has also been hurt by widely believed charges that Zhao's own children are among the more avaricious of the leadership's princelings. [redacted]

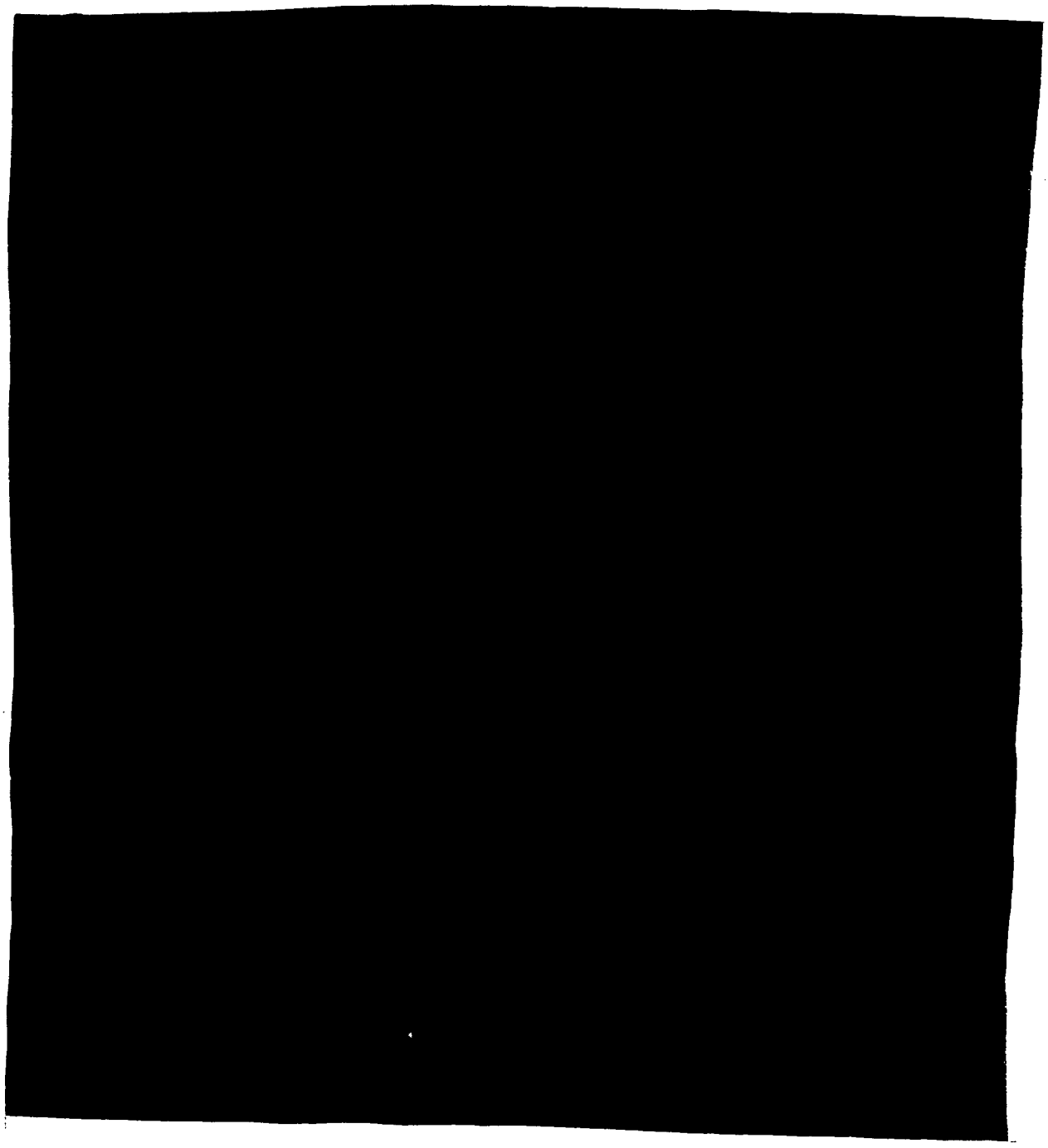
Zhao probably would also be blamed for problems in China's economy. Critics, because of personal grievances as well as policy differences, could capitalize on his advocacy of a high-growth, high-inflation policy to blame Zhao for popular discontent with the reform program and the party's handling of China's modernization program. Under Zhao, reformers have dismantled much of the central planning apparatus but have yet to establish strong fiscal and monetary tools to take its place. Thus, industrial growth reached 18.8 percent in the fourth quarter of 1988 and appeared to be accelerating despite the institution of austerity measures last September. [redacted]

[redacted]

[redacted]







[redacted]

Implications

Even if Zhao does not fall, we believe his ability to forge a consensus to get China's reform program moving again has been hurt. With Zhao weakened and the rest of the leadership so delicately balanced, we question whether China's leadership will be able to reach agreement soon on key reform measures, especially in sensitive areas such as price reform and political structural changes. [redacted]

If Zhao is ousted, we believe his successor would be even more constrained by conflicting views within the leadership. The declining prestige of the Communist Party, now increasingly perceived as riddled by corruption, and general weakening of the central government to the benefit of the provinces only exacerbate the difficulties a successor would face. [redacted]

The character of the leadership initially probably would be more conservative regardless of Zhao's successor. We believe any successor's first task would be to restore order and strengthen social discipline. He would be under considerable pressure to rely on traditional means to do so, including possible witchhunts directed against dissenting intellectuals. A limited purge of some reform leaders would be likely, though we expect any new leadership to try to coopt and employ many of Zhao's younger advisers. [redacted]

[redacted]

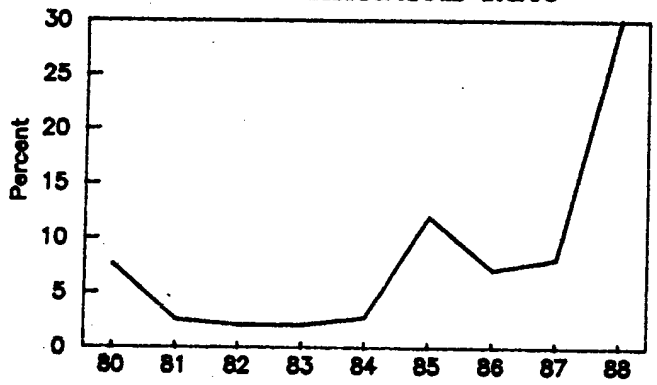
Lip service to economic and political reform experiments would probably continue in such circumstances--partly to reassure foreign investors--but the primary market-oriented economic and political reforms would be put on hold. A more conservative leadership probably would tighten conventional administrative controls to rein in the economy, abandoning price reform and other radical methods of systemic change. Such controls, in our view, would not solve China's economic problems, though they might mask them for a time. [redacted]

We would expect a post-Zhao leadership to proclaim its continued support for the open door and strong economic relations with the West. We believe, however, that China's investment climate would deteriorate. More conservative leaders would probably be less likely to favor genuine reform of the foreign trade system or other moves needed to make China's economy compatible with the GATT. At the local level, cautious officials would probably place greater restrictions on foreign investment or control of enterprises out of fear of committing political errors. [redacted]

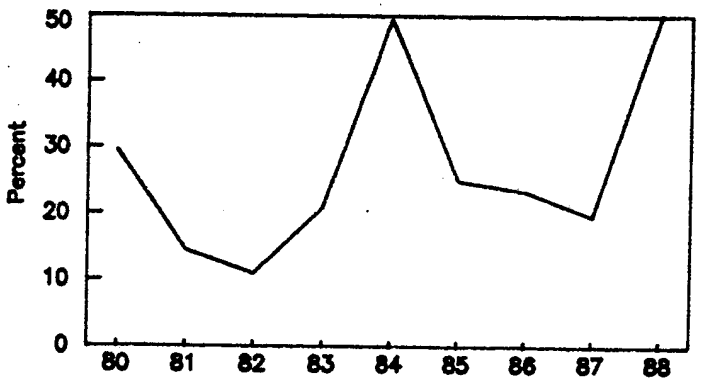
[redacted]

China: Portrait of an Overheated Economy*

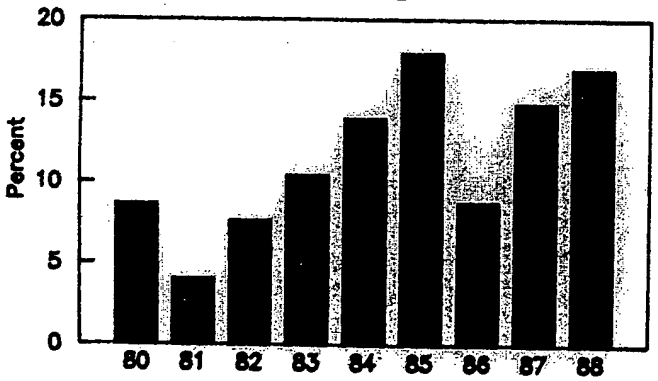
Urban Inflation Rate



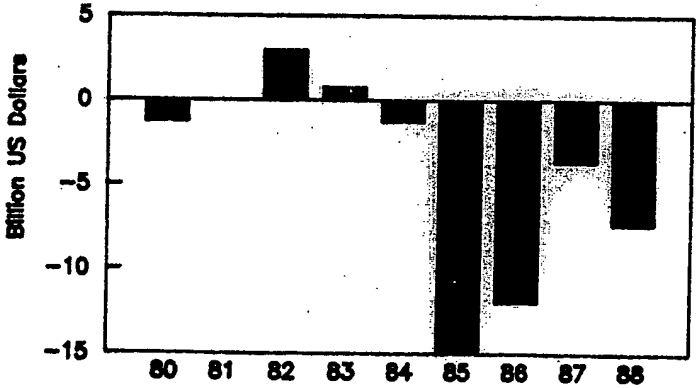
Growth in Currency in Circulation



Industrial Output Growth



Trade Balance



*Official Chinese statistics. Data for 1988 are estimated. Industrial output growth is real, rather than nominal.

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